

DOWNGRADING THE...FED

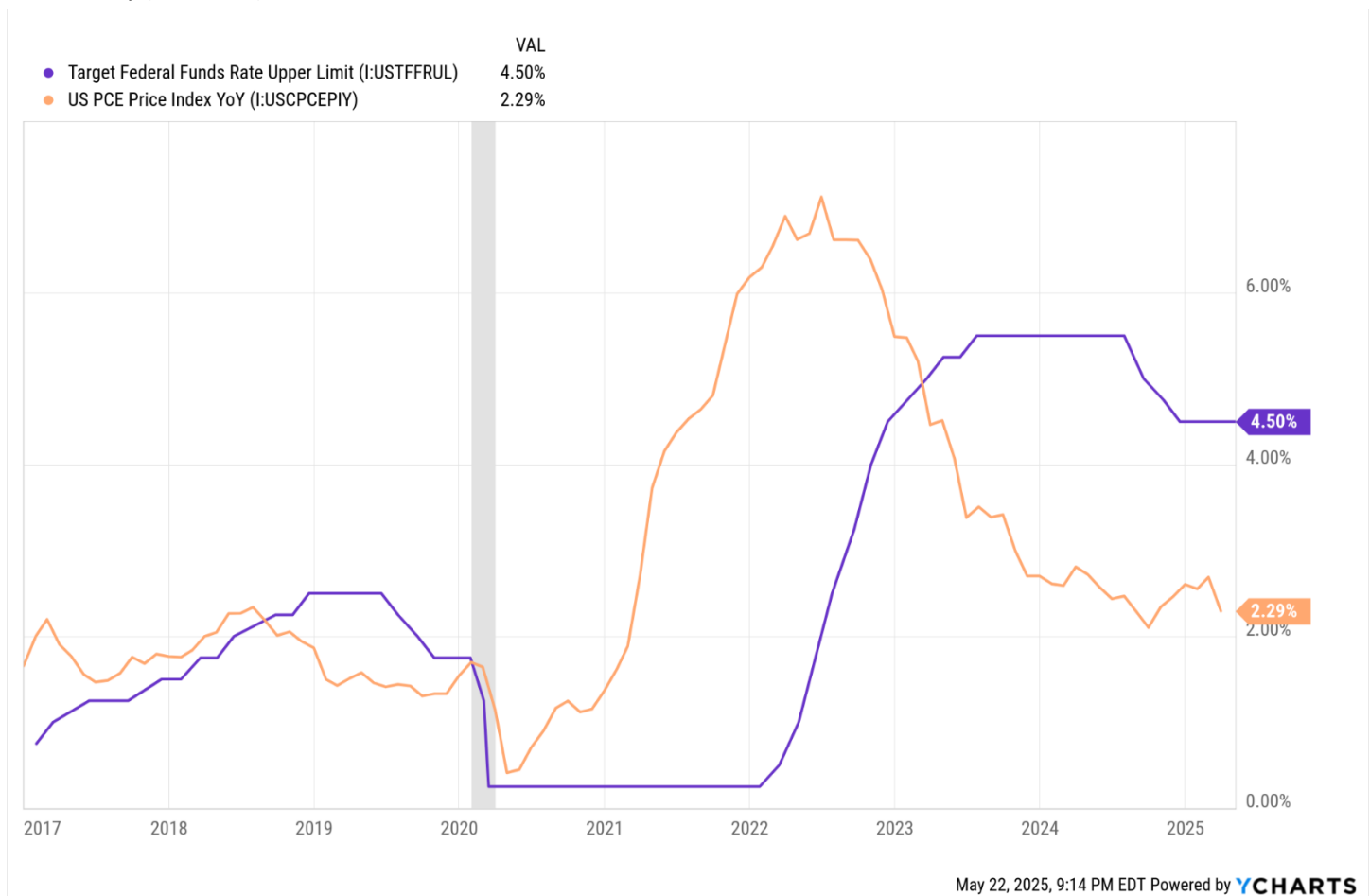
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On May 16, the third-largest credit rating agency downgraded the US sovereign rating from “Aaa” (its highest) to “Aa1” — its first such move since 1917. It will take more than a short essay to explain why, in our view, this decision is both misguided and...irrelevant. But its absurdity becomes even clearer when one considers the inevitable—yet nonsensical—sequel that followed: Having downgraded the creditworthiness of their sovereign domicile, the agency then felt compelled to follow suit by lowering the long-term ratings of...major US banks!

However, we do see an obvious candidate for an immediate (albeit symbolic) downgrade: the US Federal Reserve.

Here is why (see chart):



In the wake of the CoViD outbreak, the Fed’s second mandate—*inflation*, as measured by the PCE (Personal Consumption Expenditure, the Fed’s favored index and a close cousin of the better-known CPI)—bottomed at 0.45% in May 2020. Meanwhile, its Fed Funds rate (upper limit) was 0.25%.

What followed was a policy failure of historic proportions. Inflation surged 25-fold (!!) to 6.30% by December 2021, while the Fed stood by, insisting it was merely “transitory.”

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Having been demonstrably wrong, the Fed launched a belated campaign of aggressive rate hikes. The problem? It didn't stop when inflation peaked—PCE hit 7.2% in June 2022—but continued raising rates until they reached 5.50% in July 2023, nearly a year later. By then, inflation had already collapsed to 3.51%, meaning the Fed Funds rate stood two full percentage points—or 57%—above inflation.

Worse still, the Fed held its short-term rate at 5.5% even as inflation continued to decline, reaching just 2.47% by July 2024, before issuing its first cut. Most recently, with PCE at 2.29%, the Fed Funds rate remains elevated at 4.50%—a gap of more than two percentage points, or 96%.

The rationale? Weak:

A rotating cast of justifications—starting with fears of a recession that never arrived, followed by tariff uncertainty, and punctuated by the Fed's persistent refrain: a lack of “clear visibility” into inflation's path.

The downside? Colossal:

With the national debt at historic highs, elevated rates mean crashing debt service. Higher Fed Fund rates cascade through the economy—driving up the cost of capital for mid- and small-sized businesses and stifling the housing market. The diffuse cost of this prolonged policy error is, arguably, measured in trillions.

So, what is the diagnosis—and is there a cure?

Like much of Wall Street, the Fed remains voluntarily imprisoned in the wrong paradigm—one fixated on *predicting* the future. We see this as a debilitating yet entirely curable condition. The Fed's job should not be forecasting—it should focus on *tracking* unfolding conditions and *adjusting* in real time.

Never forecasting but constantly tracking, adjusting, risk-controlling, and tax-managing—that's the hallmark of our investment approach, and we invite you to explore the benefits it can offer you.

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